IT 98-0087-GIL 11/13/1998 Public Law 86-272/Nexus

General Information Letter: Sales of services are not protected by Public Law 86-272.

November 13, 1998

Dear:

This is in response to your letter dated November 2, 1998, in which you request a letter ruling. The nature of your letter and the information you have provided require that we respond with a General Information Letter which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. *See* 86 Ill. Adm. Code 1200.120(b) and (c).

In your letter you have stated the following:

FACTS

General

Client is in the business of providing subscriptions to an Internet-based e-mail service. The subscriptions will be sold to individuals and businesses. Client's e-mail service is available to subscribers on a nation-wide basis by way of a toll-free 800 number. Though Client's primary service is e-mail, Client's service has the capability for subscribers to send (not receive) facsimiles. Client's initial strategy is to sell its e-mail service for a flat-rate monthly fee with a separately stated additional charge for facsimile services. At some point, Client may change its pricing strategy to be based upon subscriber usage as opposed to a flat-rate fee structure. Client makes no sales of tangible personal property.

Client licenses software to original equipment manufacturers ("OEMs") to be embedded into hand-held communication devices ("devices") which the OEMs manufacture. Client receives royalties from the OEMs for the use of its software. All OEMs are located outside the United States. The OEMs sell the devices to third party retailers which, in turn, sell such devices to potential subscribers. Client is not involved in the retail or wholesale sales of the devices.

The devices utilize audio coupling technology (Client's software) to communicate with Client's computer server. This audio technology allows subscribers the ability to use the devices with any telephone (wireless or wireline) to access Client's server. Client's server is located in a state other than Illinois.

Nexus Considerations

As noted above, Client's server is located in a state other than Illinois. Client currently does not maintain a point-of-presence network in Illinois, though may establish a point-of-presence network in the future. A point-of-presence typically consists of leased space with modems and routing equipment.

As part of Client's sales/marketing strategy, it is anticipated the in-store sales personnel, of unrelated third-party retailers located in Illinois, selling Client's service-enabling device will refer potential subscribers to Client. In some instances, the in-store sales personnel may make sales demonstrations of the device and Client's e-mail service. In order to facilitate the selling efforts of the retailers, Client may train representatives of the retailers in the use of the service. The representatives would in turn train the in-store sales personnel. As an alternative, Client may train the OEMs in the use of Client's service. The OEMs would then be responsible for training the retailers. Client's training activities may or may not occur in Illinois.

Client's E-mail Service

A subscriber initiates communication with Client's server by using any telephone to dial Client's 800 number. The call is then connected to a switching station of an unrelated third-party telecommunications service provider. A Regional Bell Operating Company ("RBOC") maintains the connection between its switching station and Client's server.

Once connected to Client's server, the subscriber places the device next to the receiver of the phone, at which time information is transferred between the phone and the device via the audio coupling technology.

All applicable federal, state and local telecommunications taxes are currently paid by Client to unrelated third-party telecommunications service providers. Client does not add such telecommunications taxes to subscriber bills.

RULING REQUESTED

Client respectfully requests the following legal rulings:

1. Whether, under the facts described above, the retailers located in Illinois will likely be considered the "agents" of Client for the purpose of establishing sufficient *nexus* between Client and Illinois to subject Client to a sales/use tax collection responsibility.

2. Whether a Client-owned or leased point-of-presence in Illinois would establish sufficient *nexus* between Client and Illinois to subject Client to a sales/use tax collection responsibility.

3. Whether Client's e-mail service is subject to Illinois's sales or use tax and/or telecommunications taxes.

4. Provided Client's e-mail service is subject to Illinois's sales or use tax and/or telecommunications taxes, whether Client may rely on its subscriber's billing address to determine the appropriate taxing jurisdiction.

5. Whether Client is authorized to issue resale certificates to telecommunications service providers in purchasing telecommunications services for resale to Client's subscribers.

**Response**

Though you have asked for an opinion about nexus for sales and use and telecommunications taxes in Illinois, it is possible that your client's described activities will create nexus for purposes of the Illinois Income Tax Act (IITA). For that reason your correspondence was also referred to this, the income tax unit, for a reply. Since the product is an intangible, taxation measured by net income cannot be prohibited by PL 86-272, the federal limitation on state taxation of income derived from the sale of tangible property in interstate commerce.

Certainly, U.S. Constitutional standards dictated by the commerce clause and by due process considerations could limit taxation of your client, but those standards are in a somewhat fluid state. At least two prominent states, Michigan and New York, have used the recent opinion in *Quill Corp. v. North Dakota* (504 US 298 (1992)) as a bright line minimum for the amount of activity necessary before activity would amount to *doing business* within a state for purposes of taxation.

The Michigan case, *Magnatek Controls v. Department of Treasury* (221 Mich. App. 400, 562 N.W. 2d 219 (1997)), found that only two weeks of sales activities by a Michigan company in another state had established sufficient jurisdictional nexus in the other state to make it subject to taxation. In New York, the opinion in *Orvis v. Tax Appeals Tribunal* (86 N.Y. 2d 165, 654 N.E. 2d 954 (1995)) found that four visits to nineteen customers in one year was enough to allow the state to tax the Vermont wholesaler.

Either your client's sales/marketing strategy or its possible point-of-presence network could be enough to overcome the "slightest presence" threshold announced in *Quill* for constitutional nexus. If nexus were established for income tax, the apportionment of income to Illinois would ultimately depend upon how the sales factor would be measured. If the "income producing activity" leading to Illinois sales, measured by performance costs, were found to be proportionally greater in this state than elsewhere, then all sales of the service to Illinois customers would fall in this state's sales factor for apportionment of income. (IITA §304(a)(3)(C)(ii)).

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of 86 Il. Admin. Code Section 1200.110(b), enclosed.

Sincerely,

Kent R. Steinkamp
Staff Attorney -- Income Tax

Enc.

KS:ks